PRE-BANKRUPTCY PLANNING AND ASSET PROTECTION

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I. INTRODUCTION.

Never before in the history of the United States has there been such a high probability of being sued. Lawsuits may arise from your trade or business, such as a professional being sued for malpractice, or from the ownership of real estate or over the road vehicles. Serving as an officer or director of a corporation will also create the potential for litigation. Income tax, employment tax and the Single Business Tax can assault your personal assets. Additionally, being a general partner in a partnership or guarantying the debt of another makes you vulnerable. At the same time, traditional methods of dealing with these risks, such as liability insurance or indemnification agreements, often fail to provide the needed protection.

Persons who have accumulated substantial wealth are driven to find a means to preserve their hard earned assets while continuing to engage in their regular occupations. In typical fashion, these persons want the impossible - to insure, to the greatest extent possible, that their assets are placed out of the reach of creditors while, at the same time, maintaining maximum control over these assets.

This outline examines alternative asset protection planning mechanisms, including the use of a foreign situs trust, and the impact of bankruptcy law. Also examined are noteworthy cases where offshore trusts have been attacked with advice on how to minimize vulnerabilities. It is this author's opinion that the foreign situs trust is still a structure by which the client's objectives can be substantially realized. The outline will also address the issues that arise in connection with a sophisticated international structure.

II. THE NEED FOR ASSET PROTECTION.

A. **Proliferation of Tort Liability**.

1. Automobile and watercraft.

2. Professional malpractice.

3. Officers and Directors liability.

4. Home ownership (owner's liability for the actions of persons who have drank excessively).

B. **Internal Revenue Service and State Tax Claims**.

C. **Exposure in the Real Estate Industry**.

1. Loss of Investment.

2. Calling of Guarantees.

3. Unlimited Liability of General Partners.

D. **Protection in the Event of Divorce**.

E. **Withdrawal liability in Multi-Employer Pension Plans**.

F. **Environmental Issues**.

G. **Piercing of the Corporate Veil**.

H. **Sole Proprietorships and Partnerships**.

I. **Improprieties Leading to Personal Liability**.

1. Diversion of corporate assets.

2. Excessive fees.

3. Commingling of trust assets, improper distribution of trust funds, embezzlement.

III. OBJECTIVES OF ASSET PROTECTION.

Asset protection planning may be advantageous to clients in a variety of areas. Consider the following:

A. **Litigation Deterrence**.

B. **Creating a Strong Inducement for an Early and Cheap Settlement**.

C. **Avoiding the Necessity of Entering into a Pre-Nuptial Agreement**.

D. **Removing a Portion of a Client's Wealth from Exposure To Future Loan Guaranties**.

E. **Creating a Safety Net in the Event All Other Assets are Dissipated**.

F. **Establishing a Substitute or Supplement for Liability Insurance which may be Prohibitively Expensive or Unavailable**.

G. **Rehabilitation of Client who has Gone Bad**.

It is possible to achieve each of the foregoing objectives with a properly constructed asset protection plan. While such a plan may be subject to challenge, the client can be assured that in all likelihood his position will be much stronger following the implementation of an asset protection plan utilizing entireties ownership, partnerships, limited liability companies, and domestic and/or foreign situs trusts than it would be in the absence of affirmative planning.

IV. TRADITIONAL MECHANISMS.

A. **Joint Tenancy**.

1. A joint tenancy is a single estate in property owned by two or more individuals. Upon the death of the joint tenant, the survivor takes the entire estate by right of survivorship. The interest of a joint tenant is subject to the claims of creditors but it may not be asserted against the surviving joint tenant following the death of the decedent debtor. Because of the creditor's access to a joint tenant's interest in joint tenancy property, joint tenancies are not considered effective asset protection devices.

2. In Michigan, while both joint tenants in a bank account are alive, creditors of one of them can reach his interest in the account. MCLA §487.703. However, the surviving joint tenant takes free of the debts of his decedent co-tenant. Guilds v Monroe County Bank, 41 Mich. App. 616 200 N.W. 2d 761 (1972). MCLA §487.718. Joint interests in bank accounts are subject to garnishment and the creditor has the right to overcome the presumption that each of the parties contributed one-half of the funds. American Nat'l Bank & Trust Co. v Modderman, 37 Mich. App. 639, 195 N.W. 2d 342 (1972). Regarding creditors accessing joint interests in general, see Midgley v Walker, 101 Mich. 583, 60 N.W. 296 (1894); Czajkowski v Lount, 333 Mich. 156, 52 N.W. 2d 642 (1952); and Danielson v Lazoski, 209 Mich. App. 623, 531 N.W. 2d 799 (1995).

B. **Tenancy by the Entireties**.

1. Except for federal tax liens, a creditor of only one spouse cannot reach the debtor spouse's interest in entireties property. This has been the holding of Michigan courts for over a century. While joint creditors can reach entireties property (Matter of Grosslight, 757 F.2d 773 (1985)), entireties property cannot be involuntarily sold or encumbered for the debts of just one of them (Albinak v Kuhn, 149 F.2d 108 (1945)).

2. Absent an expression of contrary intention, a Michigan grantor of real estate to a husband and wife will be deemed to have created a tenancy by the entireties. Butler v Butler, 122 Mich. App. 361, 332 N.W. 2d 488 (1983). There is no assurance that an estate by the entireties in personal property will be created unless the parties intend to create it and document the tenancy by appropriate means (stock certificates should state "H and W as Tenants by the Entireties"). Only certain personalty qualifies for entireties treatment. (See subparagraph 3 below).

3. A little used asset protection planning opportunity in Michigan is to take title to designated types of personal property, specifically, bonds, certificates of stock, mortgages, promissory notes, debentures or other evidences of indebtedness, as tenants by the

entireties to take advantage of the entireties creditor protection afforded by MCLA §557.151. Query, what is the status of a brokerage account titled in the entireties? Would it qualify as entireties' property under MCLA §557.151 since it is the modern day method by which most persons now hold stocks and bonds or would it be deemed to be something different and therefore not statutorily entitled to entireties treatment? In Shapiro v Nicoloff (In Re Nicoloff), Civ. Case No. 01-CV-71591 DT (ED Mich 9/25/01) (Hon. Patrick J. Duggan) (unpubl.), debtor held an interest in an H & R Block brokerage account. The trustee challenged the applicability of MCLA §557.151 because brokerage accounts are not specifically listed in the statute and according to the trustee should be viewed more in the nature of a bank account. The Bankruptcy Court, which was upheld by the District Court on appeal, ruled that any distributions from the brokerage account would have been payable to the husband and wife jointly and would be protected entireties property under the doctrine established in Theisen v Theisen, 27 Mich. App. 356, 183 N.W. 2d 373 (1970).

Theisen involved characterizing the ownership status of a check payable to a husband and wife to pay off a land contract balance resulting from an earlier sale of the land by the husband and wife. Had the court concluded the proceeds to be protected entireties property because it derived from the sale of entireties property, the result would be understandable. But the court's determination that a check is an "evidence of indebtedness" under MCLA §557.151 without explanation is confusing. Indeed, see Jahn v Reagan, 584 F. Supp. 399 (1984) holding that a federal joint tax refund (which can be paid in the form of a Treasury Department check) was not an "other evidence of indebtedness" within the meaning of §557.151. Therefore, the refund was not held by them as tenants by the entireties and was not exempt from attachment or taking to satisfy the debts of one of the owners.

In the case of DeYoung v Mesler, 373 Mich. 499 (1964), a debenture was issued to a husband and wife (both names appeared on the certificate without indication of any specific type of tenancy) raising the issue whether this form of title created a tenancy by the entireties or a joint tenancy. The distinction was critical inasmuch as the plaintiff/creditor sought to reach the interest of the husband in the debenture. In a case of first impression, the court interpreted MCLA §557.151 and held that in reliance on the very strong common law rule that a conveyance to husband and wife creates a tenancy by the entirety as to real estate (except in respect to conveyances explicitly indicating that some other kind of tenancy is intended), "we are constrained to hold that the language of the statute is indicative of a legislative intent to create in the evidences of indebtedness specified in the statute an estate by the entireties." But then note the very strong dissent of Justice Souris rejecting the notion that a joint tenancy in personalty rises to "a presumption of title by the entirety."

4. A land contract vendor's interest or mortgage note payable to a husband and wife arising from the sale of real property owned by husband and wife as tenants by the entirety constitutes entireties property and each is subject only to claims of joint creditors. A mortgage interest constitutes an interest in real property. Although a land contract vendor's interest is sometimes considered personalty under the doctrine of equitable conversion, case law holds that it will be treated as entireties property if husband and wife owned the sale property as tenants by the entirety and the contract reflects both husband and wife as vendor. Commissioner v Hart, 76 F. 2d 864 (1935). Any remaining doubt as to how a vendor's interest in a land contract will be characterized for entireties purposes is now eliminated with passage

of the Land Contract Act which defines interests in land contracts as real property interests. MCL 565.357(2).

5. A tenancy by the entirety, which in its creation hinders, delays or defrauds creditors, is subject to attachment by the defrauded creditors. MCLA §566.221. See discussion of fraudulent conveyances, supra.

6. There are significant limitations to entireties planning. Upon the death of one spouse, the property will become the sole property of the surviving spouse and become subject to all pending judgments and other claims that may exist against the survivor.

7. Additionally, the laws of the various states differ as to the availability of entireties' protection, particularly in the case of personalty, and therefore, with a transient society, the applicable law at the time of dispute may be quite different from the law in effect at the time the interest was created. Conflict of laws questions are usually present. Accordingly, the use of entireties planning as a creditor protection tool has limited usefulness.

8. See Paul Steinberg's article, "Personal Property Entireties Exemption in Michigan: Does It Apply to Modern Investment Devices?" The Michigan Business Law Journal, Fall 2002, for an excellent discussion on entireties exemptions for personal property.

C. **The IRS is Victorious in its Battle to Encumber Entireties Property in Michigan**.

1. In Craft v United States, 535 U.S. 274 (2002), the entireties property of Don and Sandra Craft became subject to a notice of federal tax lien which was recorded with the Register of Deeds in Kent County, Michigan against all of Mr. Craft's property including the subject entireties property. Thereafter, the Crafts jointly transferred the property to Sandra Craft in her individual capacity. The District Court supported the Internal Revenue Service's position that the conveyance to Sandra effectively terminated the entireties estate, creating in each spouse momentarily an equal one-half interest, which was then followed by the conveyance of the property to Sandra Craft. In essence, the federal tax lien attached at the moment in time that Don Craft possessed a separate one-half interest in the property. On appeal, the Sixth Circuit reversed reasoning that, although the entireties estate was terminated upon the conveyance to Sandra Craft, Don Craft's interest in the Grand Rapids property terminated at the same time. The Court went on to say that it was unaware of any precedent indicating that an entireties estate is automatically transformed into a tenancy in common as an intermediary step in the conveyance of the property. Indeed, the Court held that at the time the entireties estate was terminated, Sandra Craft was vested with full and complete title to the property. The Supreme Court reversed.

2. The Supreme Court noted that it looked initially to state law to determine what rights the taxpayer has in the property the government seeks to reach, then to federal law to determine whether the taxpayer's state-delineated rights qualify as "property" or "rights to property" within the "compass of the federal tax lien legislation." After examining the scope of the tenancy by the entirety property concept in Michigan, the Court concluded that Don Craft had the following rights with respect to the entireties property: the right to use the property, the right to exclude third parties from it, the right to a share of income produced

from it, the right of survivorship, the right to become a tenant in common with equal shares upon divorce, the right to sell the property with his wife's consent and to receive one-half of the proceeds from such a sale, the right to place an encumbrance on the property with his wife's consent, and the right to block his wife from selling or encumbering the property unilaterally. Having found this bundle of rights, the Court easily concluded that the property rights of a spouse in entireties property is subject to the federal tax lien under §6321 of the Internal Revenue Code. The Court went on to state that though Michigan makes a different choice with respect to state law creditors in that land held by a husband and wife as tenants by the entirety is not subject to levy by execution on a judgment rendered against either husband or wife alone, the application of the federal tax lien is a federal question. The Court determined that it is not bound by the Michigan state court's answers to similar questions involving state law: "As we elsewhere have held, 'exempt status under the state law does not bind the federal collector.'"

3. The decision was 6-3 in favor of the government. Justice Thomas delivered a particularly strong dissent:

> "Rather, borrowing the metaphor of 'property as a bundle of sticks' – a collection of individual rights which in certain combinations constitute property,' Ante, at 4, the Court proposes that so long as sufficient 'sticks' and the bundle of 'rights to property' 'belong to' a delinquent taxpayer, the lien can attach as if the property itself belonged to the taxpayer. Ante, at 11.
>
> This amorphous construct ignores the primacy of state law in defining property interests, eviscerates the statutory distinction between 'property' and 'rights to property' drawn by §6321 and conflicts with an unbroken line of authority from this Court, the lower courts and the IRS. Its application is all the more unsupportable in this case because, in my view, it is highly unlikely that the limited individual 'rights to property' recognized in a tenancy by the entirety under Michigan law are themselves subject to lien. I would confirm the Court of Appeals and hold that Mr. Craft did not have 'property' or 'rights to property' to which the federal tax lien could attach."

D. **Life Insurance Products**.

1. The laws of the various states differ considerably on the accessibility of insurance proceeds and cash values by the policy owner's creditors. The New York-Type of exemption, enacted by a number of jurisdictions, has a broad anti-creditor approach. In such jurisdictions life insurance policies taken out by the policy owner, on his life or on another's life, naming someone other than the policy owner's estate as beneficiary, are free from claims of the policy owner's creditors. This applies to cash values as well as death benefits. Other jurisdictions simply limit the dollar amount of insurance that a creditor can reach.

2. Michigan had been thought by some to be one of the New York-Type states until Rotenberg was decided. The Court determined that a judgment creditor can garnish the cash value of an insurance policy, whether or not the insured has made a demand for payment. The Court based its decision on MCR 3.101(G)(1)(a) which allows the garnishment of all tangible and intangible property belonging to a principal defendant which is

in the possession of a garnishee defendant. Chrysler First Business Credit Corporation v Rotenberg v John Hancock Mutual Life Insurance Co., 789 F. Supp. 870 (1992).

3. MCLA §500.2207 establishes the rule that creditors cannot reach a beneficiary's interest in policy proceeds except to the extent necessary to recapture premiums paid on the policy which were paid with the intent to defraud creditors.

E. **Trusts**.

1. **Fraudulent transfer into trust**. If the grantor makes a conveyance into a trust, which is fraudulent as to his creditors, the creditors can void the transfer under applicable fraudulent transfer law and reach the trust assets. IV Scott, Trusts, 4th Ed, §330.12 at 372 (1989). This occurs irrespective of whether the trust is otherwise invulnerable to creditor claims.

2. **Trusts where the grantor is a beneficiary**.

a. An owner of property can properly create a trust under which a third person takes a beneficial interest, and the creditors of the grantor cannot reach this interest unless the conveyance to the trust was a fraudulent transfer. Historically, it was deemed to be against public policy to permit the owner of property to create for his own benefit an interest in that property that cannot be reached by his creditors. To the extent the grantor himself retains an interest under a trust created for a third person, that interest is subject to the claims of his creditors even though there is no fraudulent transfer issue. For example, if a grantor reserves a life income interest or reserves a power of appointment over the corpus of the trust, then the creditors will have the right to reach any such assets over which the grantor retained a power to the same extent as the grantor could under such power. (IIA Scott, Trusts, 4th Ed, §156 at 167 (1989). See below where certain states have diverted from this public policy in the greater interest of fiscal rewards. (Domestic Asset Protection Trusts – Sections 4 and 7 below).

b. Interestingly, under the general rule, the power to revoke the trust will not constitute a reserved power which renders the trust assets subject to creditor claims. Restatement of Trusts, 2d, §330, Comment o (1959). However, this general rule has been changed by statute in Michigan. MCLA §556.128 provides that a grantor who reserves a power of revocation is deemed to be the absolute owner of the estate conveyed – at least with respect to the rights of creditors.

3. **Spendthrift trusts**.

a. The rights of a creditor of a trust beneficiary-debtor are limited to the rights possessed by the beneficiary-debtor. Creditors of such a beneficiary can reach the trust interest if, and only to the same extent, that the beneficiary can compel payment of corpus to himself. Hoops, Planning for Estates and Administration in Michigan at 20:26 p. 597. Accordingly, where the trust instrument contained a spendthrift provision which applied to the income but did not limit the beneficiary's right to corpus, the creditors could reach the corpus of the trust. Perabov v Gallagher, 241 Mass. 207 (1922).

b. Consider IRS Internal Legal Memorandum 200614006 reaching the conclusion that the IRS may levy on a spendthrift trust and sue the trustee for conversion. Here the IRS concludes that where a delinquent taxpayer was a successor trustee and beneficiary of a trust and who as beneficiary has a fixed and determinable right to a stream of payments, the levy will seize not only the payments currently due but also the payments to be made in the future. Thus, if a taxpayer has a fixed right under a trust to receive periodic payments or a lump sum distribution from a trust, the levy seizes the right to such payments or distributions. According to the IRS, spendthrift provisions, which are state-created exemptions, cannot defeat a federal tax lien. The Memorandum cites authority that the federal tax lien overrides a state statute providing for exemptions. Accordingly, the spendthrift provision of the trust, however effective against certain creditors' claims, is ineffective at insulating assets of the trust from the levy of the IRS, provided that such assets are first found to constitute "property" or "rights to property" of the taxpayer. Not only is the income subject to the levy but mandatory distributions of principal at future determined dates are also considered property or rights to property and subject to seizure by the levy although the levy cannot accelerate the right to payment. So even though a federal tax levy only extends to property possessed and obligations existing at the time of the levy (except for salary and wages), future distributions of income and principal to a beneficiary from a trust are considered in existence if at the time of the levy they are fixed and determinable. The Memorandum goes on to state that as an alternative or supplement to a suit to enforce a levy, the federal government may sue the holder of the taxpayer's property for tortious conversion of the federal tax lien. Thus, a trustee is vulnerable if it makes a distribution to a beneficiary from a spendthrift trust after a levy has been served or if the trustee was aware of the levy or a federal tax lien affecting the property.

4. **Alaska trusts**.

a. Effective April 2, 1997, self-settled trusts, i.e., where the settlor names himself or herself as a beneficiary, can be created under the laws of Alaska without subjecting the trust assets to the claims of the settlor's creditors.

b. A fraudulent transfer to an Alaska trust is voidable by the creditor. Thus is maintained the one universal theme that runs through all asset protection planning - - conveyances which are fraudulent under a state's fraudulent conveyance laws or fraudulent transfer laws will be ineffective against the transferor's creditors. While the facts of a particular transfer need to be analyzed to determine whether a conveyance is fraudulent, or whether the applicable Statute of Limitations has foreclosed the claim, once determined to be a fraudulent transfer and if timely pursued under the Statute of Limitations, the transfer can be voided by the creditor.

c. The Alaska Trust Act, Chapter No. 6, SLA 1997, permits a person who, in writing, transfers property in trust, to provide that the interest of a beneficiary may not be voluntarily or involuntarily transferred before it is paid or delivered to the beneficiary. When such a provision is present, no current creditor nor any person who subsequently becomes a creditor may satisfy a claim out of the beneficiary's interest in the trust unless one of the following four exceptions applies:

i. To the extent the settlor retains the power to revoke or terminate all or part of the trust without the consent of a person who has an adverse interest.

ii. To the extent that the trust income and/or principal must be distributed to the settlor.

iii. To the extent that at the time of the transfer to the trust, the settlor was in default by thirty or more days in making a payment due under a child support judgment or order.

iv. To the extent the transfer was intended, in whole or in part, to hinder, delay or defraud creditors under the Alaska Fraudulent Transfer Law.

The creditor must bring his action timely. For claimants who were creditors when the trust was created, the action must be brought within the later of four years after the transfer to the trust or one year after the transfer is or could have been reasonably discovered. Claimants who become creditors after the transfer may maintain an action based upon a fraudulent conveyance theory only if it is commenced within four years after the transfer to the trust.

d. The Alaska law specifically protects the settlor spouse against the claims of the other spouse in a divorce action. AS 13.36.310. Thus, judgments for spousal support or alimony cannot reach trust assets.

e. If the client is a resident of a state other than Alaska and creates an Alaska trust providing for Alaska law to apply, will the creditor who brings an action in a jurisdiction other than Alaska, claiming that the law of the debtor's domicile should control, be effective to defeat the spendthrift trust provisions of the new Alaska law. Unfortunately, such questions have yet to be answered. However, a review of In re Larry Portnoy, 201 BR 685 (SDNY 1996) may be instructional. In Portnoy, the debtor established a Jersey (Channel Islands) trust when he was aware of financial problems in his 100% owned corporation for which he personally guaranteed a significant debt. Later, during settlement discussions regarding his guaranty, Portnoy misrepresented that he had no assets. Not only did the bank eventually determine that he had stashed his money offshore but that he had also concealed the transfer of his salary payments to his daughter and wife. The court opted to apply New York law as opposed to Jersey's substantive law because of the perceived abuses in Portnoy's behavior. Accordingly, the Bankruptcy Court refused to grant a discharge when it found that Portnoy's behavior offended both New York and federal bankruptcy policies. A common theme emerges from the very abusive cases . . . somehow the court will find a way to punish the wrongdoer irrespective of traditional legal notions. (See Section 7 below for a more extensive discussion of domestic asset protection trusts ("DAPT") and the impact of federal bankruptcy law).

f. The "full faith and credit" clauses of the United States Constitution provide limitations on, or possibly render ineffective, the full extent of the asset protection intended by the Alaska law.

i. All states are bound by the full faith and credit clause of Article 4 § 1 of the United States Constitution. Also known as comity, Alaska courts must recognize judgments rendered under the laws of her sister states. However, it is unlikely that an Alaska court will enforce a judgment of a sister state against an Alaska asset protection trust when a different result would have been reached under Alaska law.

ii. This problem does not come up in traditional offshore asset protection planning where the foreign jurisdiction is chosen, in part, based upon its refusal to recognize foreign judgments including judgments of a U.S. Bankruptcy Court.

g. Alaska has eliminated its Rule Against Perpetuities.

h. Alaska insures that the financial costs of establishing an Alaska trust inures to the benefit of the state and/or its residents. For example, some trust assets must be deposited in Alaska and the assets must be administered by an Alaska domiciliary, an Alaska trust company or a bank. The Alaska trustees' duties must include an obligation to maintain records for the trust and be involved in the preparation of the trust's income tax returns. Part of the trust administration must occur in Alaska.

5. **Delaware trusts**.

a. Delaware is loathe to give up its stranglehold on new corporate formations and existing corporations which have Delaware as their state of incorporation. This business brings in substantial fees to the state as well as to non-governmental companies offering collateral services within the state. In this spirit, Delaware smelled the potential from establishing laws attractive to persons interested in protecting their assets from the claims of creditors. Why should a U.S. person have to go offshore if the same services are available on shore.

b. The Delaware trust law is similar to the Alaska trust law.

c. Delaware, like Alaska, has veered from the universal policy that a settlor cannot establish a spendthrift trust where the settlor is a protected beneficiary.

d. The Delaware Statute of Limitations for fraudulent conveyances to a Delaware trust is identical to that established under the Alaska statute.

e. To further strengthen its competitive position, Delaware law provides specific protective language for trustees acting in good faith. It allows them to lien the customer's assets to aid in collecting their fees as well as establishing a presumption that the trustee did not act in bad faith merely by accepting property later determined to be fraudulently conveyed.

6. **Other DAPT States**.

Other states have adopted laws which permit self-settled trusts in an attempt to compete in the domestic asset protection arena. For Nevada and Rhode Island Trusts see Nev. Rev. Stat. Ann. §166.0401 (Michie Supp. 1999) and R.I. Gen. Laws §18-9.2 (Supp 1999), respectively. The later arrivals are Missouri, Missouri UTC, Mo. Rev. Stat. §465.5-505.3; Oklahoma, Oklahoma Wealth Preservation Trust Act, 31 Okla. Stat. §10, et. seq.; South Dakota, S.B. 93 and S.B. 94 adopted March, 2005; and Utah, Utah Code §25-6-14.

7. **Domestic asset protection trusts in bankruptcy**.

The question of whether a domestic asset protection trust can withstand an attack by a creditor in bankruptcy has been plaguing asset protection planners since Alaska first enacted its domestic asset protection legislation in 1997. Although self-settled trusts are generally recognized under Bankruptcy Code §541(c)(2) "applicable non-bankruptcy law" generally meaning state law must still be applied to the DAPT. If the DAPT is established in Alaska and the debtor is a Michigan resident the question is whether Michigan law, which does not recognize self-settled trusts, takes precedence over Alaska's statutory scheme recognizing self-settled trusts. David G. Shaftel and David H. Bundy analyze state law and federal bankruptcy law in their article Domestic Asset Protection Trusts and the Bankruptcy Challenge, Estate Planning Journal (WG&L) (2005).

Conflict of laws and choice of law provisions become a significant aspect of the analysis to determine the applicable state law. If the Alaska trust unequivocally provides that Alaska law shall control the trust, does that become binding upon the bankruptcy court or will the bankruptcy court consider that the non-recognition of self-settled trusts in Michigan is a strong public policy of the state and therefore the exclusion of the self-settled trust from the bankruptcy estate would violate that policy. In such cases the bankruptcy court could disregard Alaska law in favor of Michigan law. Although no cases have yet been decided that are responsive to this question, analogous cases involving foreign asset protection trusts have recognized that state law will control notwithstanding designation of the foreign jurisdiction as the applicable law. Note the cases of Portnoy, 201 B.R. 685 (B.K.) S.D. N.Y. (1996); Affordable Media, LLC, 179 F3d 1228 (C.A. – 9, 1999) and In Re: Lawrence, 279 F3d 1294 (C.A. – 11, 2002) all of which involved egregious examples of fraud; query whether in the absence of such circumstances the laws of the trust's situs would have been ignored.

Commentators feel that a DAPT settlor can maximize the chances of preserving the DAPT by preplanning and careful structuring such as executing the trust agreement in the DAPT state and generating as many connections to the state as possible; for example, purchase a vacation home in the state and visit it regularly, the only trustee of the trust should be a DAPT state resident or institution and the trust assets should be transferred to DAPT state and administered there along with all the records. In addition, the trust should rigorously comply with the DAPT state law in all regards including its fraudulent transfer laws. This type of preparation should give the settlor a reasonable set of facts upon which to argue that the DAPT state law should be applied and therefore the trust should be respected in bankruptcy. Nonetheless, until there are definitive decisions in this area, settlors need to be wary.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added a provision dealing specifically with self-settled trusts. Bankruptcy Code §548(e)(1) provides that a trustee may avoid any transfer of an interest of the debtor in property that was made on or within ten years before the date of the filing of the petition if such transfer was made to a self-settled trust, such transfer was by the debtor, the debtor is a beneficiary of such trust and the debtor made such transfer with actual intent to hinder, delay or defraud any *entity* (italics added) *to which the debtor was or became* (italics added), on or after the date that such transfer was made, indebted. Section (e)(2) provides that a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by or that are believed would be incurred by any violation of federal or state securities laws (as defined) or by fraud, deceit or manipulation in a fiduciary capacity in connection with the purchase or sale of any registered security. It appears that the promoters of the legislation were concerned about the high profile cases of the day where senior executives "cooked the books" or diverted funds for their own purposes. In such cases should such individuals have established self-settled trusts that would otherwise be outside the normal fraudulent conveyance statute of limitations (whether under bankruptcy law or applicable state law) the ten-year rule will come into play. Note however that the ten-year rule for self-settled trusts is not limited to the specified situations but includes any transfer with intent to hinder, delay, defraud any entity to which the debtor ultimately becomes indebted.

Although not involving trusts *per se* a related change now makes certain bonuses and other payments to corporate insiders subject to rescission if the transfer was part of an employment contract, the transfer benefited the insider and the transfer was not in the ordinary course of business. Bankruptcy Code §548(a) and (b) are applicable to bankruptcy cases commenced more than one year after enactment of the Act.

V. THE FAMILY LIMITED PARTNERSHIP.

A. In general.

1. Family partnerships offer both income and estate tax savings possibilities. In its ordinary form, father may contribute his business tax free to a limited partnership, reserving a general partner interest for himself and gifting limited partnership interests to his children. If there were no unusual restrictions in the limited partnership agreement regarding distributions to partners or their assigning their partnership interests to others, the gifts would be considered gifts of a "present interest" and qualify for the $12,000 (after 2005) annual gift tax exclusion under IRC §2503(b). If the value of the gift to any donee exceeds $12,000 ($24,000 in the case of a gift consented to by the spouse), a gift tax return will have to be filed and the donor's unified credit, to the extent then available, will be applied. In valuing the gift, the advisor should consider taking a discount for minority interest and lack of marketability factors. The retained interest cannot confer a discretionary liquidation, put, call or conversion right or the retained interest will be accorded a zero value in the determination of the fair market value of the gift. IRC §2701.

2. If capital is a material income producing factor in a partnership's production of income, the donee child of a partnership interest will be considered a partner and will receive his distributive share of partnership income. The 35% maximum individual income tax rate provides a strong incentive to shift income to the lower bracketed individuals. However, with respect to a family member under age 14, the "kiddie tax" generally taxes the unearned income of such child in excess of $1,200 at his parent's top rate.

3. With a business that is appreciating in value, the gift of an interest in the limited partnership owning such business may effect an estate tax freeze as to the transferred interests with consequent estate tax savings to the donor. The donor must not retain excessive control or control over the receipt of the income from the partnership or the gifted interests will be pulled back into the donor's estate under IRC §§2036 or 2038. See <u>Strangi</u>, 96 AFTR

2d 2005 – 5230 (CA – 5, 2005), the pivotal case in an evolving area of the law, as the IRS challenges this planning technique.

4. Family partnerships present multiple opportunities for tax abuse. Accordingly, the Internal Revenue Service will pay close attention to the partnership agreement and the business being conducted by the partnership. IRC §704(e) states that "a person shall be recognized as a partner . . . if he owns a capital interest in a partnership in which capital is a material income-producing factor . . . ". This is a critical area of inquiry for the Service. Where capital is not a material income-producing factor, income of the partnership will be reallocated to the service provider to the extent that the service is rendered by him and the balance would be divided in accordance with the respective partnership interests of the partners. Reg. 1.704-1(e)(1)(i).

5. Recognition of a donee's interest in a limited partnership is based upon the donee's acquisition of dominion and control over the interest purportedly transferred to him. Reg. 1.704-1(e)(2)(ix) makes it clear that the absence of services and participation in management by a donee of a limited partnership interest is immaterial if the limited partnership meets all the other requirements prescribed in the Regulations. This qualification is necessary since, in the absence of such a rule, the limited partner would be required to actively engage in management which would expose him to treatment as a general partner with loss of limited liability protection.

6. Probate Advantages - Assets in multiple jurisdictions can be contributed to the partnership and thereby avoid ancillary probate proceedings.

7. The family limited partnership structure facilitates transfers among family members beyond the initial organization phase. As children grow into management positions, additional interests in the partnership can be transferred to them by gift or sale.

B. **As an asset protection vehicle**.

1. Assets contributed to a family limited partnership in a transaction which does not constitute a fraudulent conveyance will obtain a degree of protection from the partner's creditors.

2. The creditors of the partner have no right to any property owned by the partnership including cash. Creditors can only reach assets specifically securing the debt or assets which have not been transferred to the partnership by the debtor partner. In IRS Legal Memorandum 199930013 the IRS agreed that these rules are equally applicable to it as a creditor of a taxpayer. Fred Stevens was the sole member of a single-member limited liability company that is disregarded for federal tax purposes. The question raised was whether the IRS can levy on the LLC's assets to satisfy Fred's tax liabilities. The Memorandum stated that the IRS has no right to file a lien against the assets of the LLC since the LLC is a legal entity distinct from its members and a member is not a co-owner of and has no transferable interest in the property of the LLC. And the IRS has the same rights as any other creditor as regards accessing distributions from the LLC. Note that the charging order language in the Michigan Limited Liability Company Act is identical to the language in the Michigan Uniform Limited Partnership Act. Interestingly, the IRS Memorandum noted other collection options available

to the IRS namely the charging order approach on the one hand and filing alter ego liens against the LLC under state law principles permitting a creditor to disregard a business entity analogizing to the piercing of the corporate veil in the corporate context. The IRS Memorandum says it may be possible to use this doctrine to disregard an entity organized as an LLC where the taxpayer is using the LLC form to shield assets from the IRS, such as where income earned by the taxpayer is being paid directly to the LLC.

3. The creditors' sole remedy is to obtain a charging order under MCLA 449.1703 (§703 Revised Uniform Limited Partnership Act). It reads,

> "Upon application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest . . ."

MCLA 449.1702 provides that an assignment entitles the assignee to receive, to the extent assigned, only the distribution to which the assignor would be entitled. The assignee does not automatically become a substituted limited partner.

4. The effect of a charging order is to garnish any distributions due the debtor partner from the partnership. To the extent no distributions are made, the judgment creditor receives nothing. Typically, the partnership agreement will give the general partner broad discretion as to the distribution of the partnership's income (as well as other assets) - thereby controlling the creditors access to such distributions.

5. The charging order may not cover fees paid to the general partner in consideration of services rendered since these are in the nature of compensatory payments as opposed to partnership distributions. Likewise, loans may be made to the debtor partner without violating the terms of the charging order.

6. Consider this tax anomaly. Since the creditor is considered an assignee of the debtor limited partner for tax purposes, the judgment creditor is taxed on the assignee's allocable share of income. Rev. Rul. 77-137, 1977-1 C.B., 178. This situation may provide additional leverage to negotiate a favorable settlement with the creditor.

7. Since the creditor cannot reach the assets of the partnership, and only becomes an assignee and not a substituted limited partner, the creditor has no rights as a partner. But see the several California cases cited below where the creditor foreclosed on the debtor partner's partnership interest.

8. There are disadvantages of the family limited partnership as an asset protection technique.

a. General partner is a fiduciary of partnership and fees paid to general partner and others may be questioned as to reasonableness.

b. A creditor's remedy may not be limited to a charging order. In Centurion Corp. v Crocker National Bank, 208 C.A. 3d 1, 255 Cal. Rptr. 794 (1989), a court determined it could order the sale of a debtor/partner's interest in a limited partnership if three factors were present: (a) charging order in effect, (b) debt remained unsatisfied and (c) all partners except debtor/partner consented to sale. In Hellman v Anderson, 233 C.A. 3d 840, 284 Cal. Rptr. 830 (1991), the court said that a creditor can foreclose on the debtor/partner's general partnership interest if this would not unduly disrupt the business of the partnership - even if the other partners did not consent.

c. In a partnership formed under the Uniform Partnership Act, the language regarding a creditor's right to obtain a charging order is somewhat more expansive than under the Revised Uniform Limited Partnership Act. MCLA 449.28. Under the UPA, a court may, in addition to entering a charging order, make all of the orders, directions, accounts, and inquiries which the debtor partner might have made, or which the circumstances of the case may require. This was, in part, the basis upon which the court in Hellman affirmed a foreclosure of the debtor's partnership interest. The Centurion court went further and applied the same standards to a limited partnership interest.

d. **Bankruptcy**:

i. Some case law suggests that a partner's management rights constitutes property which can be reached.

ii. Bankruptcy of a limited partner does not dissolve the partnership (MCLA 449.1801). However, bankruptcy trustee may be able to force partnership to buy out bankrupt partner's interest at fair market value. Federal Bankruptcy Code §541(a)(1), MCLA §§603 and 604.

iii. If partnership is not making distributions to avoid payment to trustee in bankruptcy, trustee may be able to dissolve the partnership based on a breach of fiduciary duty.

iv. The judgment creditor who holds the charging order does not become the owner of the interest unless he actually purchases it pursuant to the statute. Such purchase, of course, gives the creditor the improved position as a partner over its position as a lienor of partnership distributions and could well give the creditor access to partnership assets by controlling distributions.

9. Attacks on Partnerships Established for Asset Protection.

Interpool Limited v Barry Patterson, et al., 890 F. Supp. 259 (1995) involved a defendant, Cuneo, who was being sued for common law fraud and breach of fiduciary duty. Shortly before the case was scheduled to go to trial Cuneo conveyed substantially all of his non-exempt assets to a limited partnership of which he and his wife were the sole partners. The partnership agreement was drafted with the intent to maximize protection against creditors. A provision in the partnership agreement provided in substance that the taking or encumbering of a partnership interest by levy, foreclosure, charging order, execution or other similar involuntary proceeding is deemed a prohibited transfer. It is also stated that a creditor who brings an action resulting in such a taking or encumbrance is to be treated as an assignee of the partnership interest and may receive only such distributions of net cash flow attributable to that interest as are properly disbursed. The creditor, however, is prohibited from taking any role in the management of the partnership.

The court determined that the contribution by Cuneo of all or substantially all of his non-exempt assets to the partnership in exchange for general and limited partnership interests in an entity in which he and his wife were the sole partners left him substantially judgment proof. After analyzing the fraudulent conveyance acts in effect in both New York and Florida the court determined that these transfers constituted a fraudulent conveyance. Cuneo argued that the partnership interests that he obtained constituted a fair equivalent for the property transferred to the partnership. In response the court found that the value of the partnership interests bore no reasonable relationship to the value of the property surrendered. Moreover, the court held that the analysis of value is made from the creditor's perspective rather than from the debtor/transferor's perspective. Furthermore, the court found that conveyances are made for "fair consideration" only if a fair equivalent was received and it was made in good faith. The court found in this case that the conveyance was not made in good faith since, among other things, the debtor had knowledge of the fact that the activities in question would hinder, delay or defraud others.

What is learned from the Interpool Limited case is that even though a debtor receives a partnership interest in exchange for the transfer of non-exempt property, this will not be deemed to constitute fair consideration – one of the critical factors in determining whether a fraudulent conveyance has occurred. In this case there were no business reasons proffered by Cuneo for creating the partnership. In cases where estate tax savings, asset consolidation or management controls justify the creation of a partnership, it may be more difficult for a court to challenge the transfer as being fraudulent.

Ehmann v Movitz, 319 B.R. 200; 2005 Bankr. LEXIS 80, January 13, 2005 is illustrative of how a trustee in bankruptcy can overcome the contractual provisions of an operating agreement (or partnership agreement) utilizing §541 of the Bankruptcy Code. Conversely, by including certain key provisions in an operating agreement it may be characterized as an executory contract subject to the provisions of §365(c) and (e) of the Bankruptcy Code.

In Ehmann the trustee sought among other things a declaration that the trustee has the status of a member in the limited liability company. The LLC relied heavily on various provisions of the operating agreement which provided that in the event a trustee acquires a member's interest, such action shall not dissolve the company or entitle "any such assignee to participate in the management of the business and affairs of the company or to exercise the right of a member unless such assignee is admitted as a member…". "Such an assignee that has not become a member is only entitled to receive to the extent assigned the share of distributions…to which such member would otherwise be entitled with respect to the assigned interest". The LLC noted that such limitations on the rights of assignees of members' interests in LLC's are specifically authorized by state law. The LLC also argued that the trustee is akin to a judgment creditor and that Arizona law provides that a charging other is the exclusive remedy by which a judgment creditor of a member may satisfy a judgment out of the members' interest in the LLC.

The decision in the case revolved around whether the operating agreement is an executory contract between members and the LLC. If considered an executory contract, §365(e)(2) of the Bankruptcy Code allows such provisions to be enforceable against the trustee. If, however, the operating agreement is not considered an executory contract, §541(c)(1) allows the trustee to acquire all of the debtor members' rights and interests in the LLC.

First the court defined what an executory contract is. Reciting the "Countryman Test", a "contract is executory if the obligations of both parties are so far unperformed that the failure of either party to complete performance constitutes a material breach and thus excuses the performance of the other". In examining the operating agreement, the court found that the members had virtually no obligations and therefore the operating agreement was not an executory contract. In a discussion of the types of obligations that members might have that would give rise to an executory contract by far the most important would be the potential obligation of a member to make additional capital contributions. Thus, asset protection planners should consider including such a provision in operating agreements and partnership agreements when establishing such an entity with asset protection planning in mind.

VI. RETIREMENT PLANS AND EDUCATION SAVINGS ACCOUNTS.

A. Qualified Plans.

In 1992, the U.S. Supreme Court in Patterson v Shumate, 504 U.S. 753 put to rest the controversy over whether a participant's interest in a qualified retirement plan under ERISA is protected from the participant's creditors. It was uncontroverted that the anti-alienation provision required to be contained in ERISA plans protected participants from their creditors attempting to levy or attach their interest in the Plan outside of bankruptcy. However, the question remained whether in bankruptcy the employee debtor's interest in the Plan fell within the exclusion from the bankruptcy estate provided under §541(c)(2) of the Bankruptcy Code. This section excludes from the bankruptcy estate all property subject to a restriction on transfer which is enforceable under "applicable non-bankruptcy law." In resolving a conflict among circuits, the Supreme Court stated:

> "Our holding gives full and appropriate effect to ERISA's goal of protecting pension benefits…this Court has described that goal as one of ensuring that 'if a worker has been promised a defined pension benefit upon retirement – and if he has fulfilled whatever conditions are required to obtain a vested benefit – he actually will receive it…Our holding furthers another important policy underlying ERISA: uniform national treatment of pension benefits…construing 'applicable non-bankruptcy law' to include federal law ensures that the security of a debtor's pension benefits will be governed by ERISA not left to the vagaries of state spendthrift trust law."

In advising clients, counsel can be comfortable that qualified plan assets are outside the reach of the participant's creditors.

A thorny issue exists as to what plans are qualified under ERISA. In general, it has been accepted that if the plan is qualified for tax purposes under the Internal Revenue Code it is therefore a qualified ERISA plan. Several cases have dealt with this issue. See for example In re: Hall, 151 B.R. 412 (Bankr. W. D. Mich. 1993). See also In re: Youngblood, 29 F. 3d 225 (5th Cir. 1994).

B. **Individual Retirement Accounts – Pre Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPA)**.

IRA's are treated very differently from ERISA qualified plans. They are not covered under the protection of the U.S. Supreme Court's holding in Patterson v Shumate. In Michigan there has been significant disagreement by the courts as to the degree of protection afforded to IRA's both outside and in bankruptcy. Sometimes different judges in the same court disagreed on the exemption issue for IRA's. A 1998 Sixth Circuit Court of Appeals decision brought to an end the differences in approaching the IRA exemption in bankruptcy. See Section 2 below.

1. **Outside of Bankruptcy**. With respect to the vulnerability of IRA's outside of the bankruptcy context, the current law is based upon the decision in Lampkins v Golden, 28 Fed. App. 409, 2002 W. L. 7449, (6th Cir. 2002). Plaintiff attorney Robert Golden maintained both a profit sharing trust and pension trust. His professional corporation was sued by a secretary alleging breach of fiduciary responsibilities. The District Court granted summary judgment to the secretary and ordered the Defendant to pay the secretary her accrued benefits due from each of the plans. Golden refused to pay the judgment claiming that he had no assets or income but it was discovered that Mr. Golden had placed assets in an individual retirement account which had been created as a Simplified Employee Pension Plan. The secretary sought garnishment of the SEP assets. The court ruled (i) that Golden's IRA was exempt from the anti-alienation provision under ERISA inasmuch as the IRA qualified as an Individual Retirement Account under Code Section 408(k), (ii) because MCLA §600.6023(1) exempted all Section 408 Individual Retirement Pension Plans from garnishment, while ERISA would allow garnishment of those funds, the Michigan statute clearly related to the ERISA Plan in question; (iii) as a result, the Michigan statute was preempted under federal law. Accordingly, Defendant Golden's IRA was subject to garnishment.

IRA's are clearly not subject to the anti-alienation provision of ERISA in that §29 U.S.C. §1056(d)(1) provides the exception "this part shall apply to any employee benefit plan described in Section 1003(a) of this title…other than …. (6) individual retirement account or annuity described in Section 408 of Title 26… . "Since the Simplified Employee Pension or SEP is an individual retirement account it is not protected by the anti-alienation provision.

MCLA §600.6023(k) provides that "an individual retirement account or individual retirement annuity as defined in Section 408 of the Code is exempt from levy and sale under any execution." One would think this is dispositive of the issue and that the IRA is protected. However, as analyzed in Lampkins the state exemption is preempted under ERISA. Because the anti-alienation provision of ERISA is not applicable and therefore ERISA would allow garnishment of those funds, and the Michigan statute is contrary thereto, the language of ERISA Section 1144(a) to the effect that "the provisions of this subchapter and subchapter III of this chapter shall supersede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan" compels a finding of preemption.

2. **IRA's in Bankruptcy**. With the decision in In re: Jerald E. Brucher, 243 F 3d 242 (6th Cir. 2001), the quagmire of decisions relating to the exemption of IRA's in a bankruptcy setting came to an end. The issue is whether and to what extent §522(d)(10)(E) of the Bankruptcy Code applies to exempt a debtor's IRA from inclusion in the bankruptcy estate. Not only was there a dichotomy of thought in Michigan but confusion from conflicting interpretations and decisions was pervasive around the country. Courts attempted to analyze the issue based upon whether IRA assets should be available to pay a debtor's creditors or should be reserved for the debtor as part of the "fresh start" concept of bankruptcy. Also, the courts were hung up on whether the exemption applied to the account balance as a whole or only to the right to receive a payment on account of the illness, disability, death, age or length of service of the debtor, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor. Following the Fifth Circuit's decision in In re: Carmichael, 100 F. 3d 375 (5th Cir. 1996), the Sixth Circuit in Brucher found that in bankruptcy the IRA is exempt property.

C. **Tax Exempt Retirement Plans under BAPA**.

1. **General**. As discussed above, not all retirement plans were excluded from the bankruptcy estate under §541(c)(2). In particular, IRA's, government and church plans were not ERISA-qualified and entitled to exclusion. Under BAPA, retirement accounts that are tax-exempt under the Internal Revenue Code are exempt from the debtor's estate subject to a $1,000,000 cap for IRA's. The asset limitation does not apply to funds saved in a Simplified Employee Pension under IRC §408(k) or a Simple IRA under IRC §408(p). Under BAPA, the limit may be increased "if the interests of justice so require". The amount is to be indexed for inflation under Bankruptcy Code §104. Exempt funds include those for which a favorable determination under the IRC has been received as of the date of the commencement of the case and those for which no determination to the contrary has been made if the fund is in substantial IRC compliance. Even if the fund is not in substantial compliance, the debtor may claim the retirement funds as exempt if the debtor is not materially responsible for the failure.

2. **Rollovers**. BAPA addressed the question of what happens when the accounts of ERISA qualified plans which are protected from creditors in bankruptcy (see discussion re: Patterson v Shumate above) become commingled with or are rolled over into IRA's which are subject to the $1,000,000 cap. Congress adopted the logical approach being that an exempt fund does not lose its protected status based on a direct transfer or eligible rollover as long as the funds came from a qualified account and are deposited in the IRA within 60 days from the date of distribution. Rollover assets are protected without dollar limitation.

3. **Supreme Court Decision.** In Rousey v Jacoway, 125 S. Ct. 1561 (2005), the Supreme Court clarified that IRA's are exempt from the bankruptcy estate under Code Section 522(d)(10)(E) because they fulfill the purposes of statute. They confer a right to receive payments based on age and are similar to other plans or contracts cited in the law that are exempt. However the exemption was not unlimited. Under Code Section 522(d)(10)(E)

debtors could shield their IRA's from creditors only to the extent that money is "reasonably necessary for the support of the debtor and the debtor's dependents." As it turned out the effect of Rousey was short-lived. The decision was rendered moot by BAPA. See Section 4 below.

4. **Traditional IRA's versus Roth IRA's**. The Supreme Court's decision in Rousey was based in part on the penalties and restrictions imposed upon traditional IRA's. Questions had been raised prior to the Supreme Court's decision as to whether the same creditor protections available under state exemption laws that applied to traditional IRA's also shielded Roth IRA's. Since Rousey dealt with traditional IRA's, there may be a period of uncertainty for cases arising prior to the effective date of BAPA; that is 180 days after enactment or October 17, 2005. BAPA did not distinguish between traditional IRA's and Roth IRA's and thus the protections discussed above are applicable to both.

5. **Retirement Plan Loans**. Amounts owed to qualified retirement accounts are not dischargeable in bankruptcy. Furthermore, the plan is excepted from the automatic stay that would otherwise apply to the withholding of payments from a qualified retirement plan for purposes of repaying the loan.

D. **Education Savings Accounts**.

Section 529 Plans as well as prepaid tuition plans have gained increasing popularity as parents and grandparents seek tax favored opportunities to save for their beneficiaries' educational expenses. The extent to which such plans are vulnerable to the claims of creditors varied from state to state and was also dependent upon who was considered the owner of the assets – the contributor, the account owner (the parent may be the account owner while a grandparent is the contributor) or the beneficiary. It was also unclear whether a non-resident debtor would enjoy a state's creditor protections if he or she made contributions to a plan in another state. BAPA answers these questions by providing that such accounts are free from the claims of creditors subject to certain limitations. Funds placed in IRC qualified education savings accounts as well as prepaid tuition plans are exempt provided the designated beneficiary is a child, stepchild, grandchild or step-grandchild of the debtor for the tax year in which the funds were placed into the account. Adopted children and those placed in the debtor's household to be adopted also qualify, as do foster children or members of the debtor's family and whose principal residence is the debtor's home. Qualified funds include those placed in a qualified education individual account within a year of the petition date that are not excess statutory contributions and not pledged or promised to any entity in connection with any extension of credit. For contributions placed in an account or accounts having the same beneficiary within 365 to 720 days before filing, the exemption is limited to $5,000.00 dollars. The debtor must file with the court a record of any interest he has in qualified educational savings accounts or qualified state tuition programs. Act §25.

VII. PROPERTY EXEMPTIONS.

Well advised debtors have enjoyed a significant opportunity to shelter assets from creditors even in bankruptcy by taking advantage of certain states' unlimited homestead exemption. This was perceived to be a source of abuse and was remedied by a series of rules enacted as part of BAPA. The system of state law exemptions whereby debtors either were forced to utilize state exemptions or could choose between state and federal exemptions provided an array of opportunities in that debtors could choose an appropriate forum to maximize the homestead exemption. BAPA did not eliminate state exemptions which had been recommended by the National Bankruptcy Review Commission. Nonetheless, the new rules discourage debtors from seeking out favorable homestead exemption states by requiring lengthier periods of residence to qualify.

The first significant rule change is that a debtor is bound by the exemptions of his or her prior state of residency unless he has established residency in a new state for at least two years (this changes the existing six-month rule).

To understand the impact of these rules consider the Havoco case. Havoco of America, Ltd. v Hill, 255 F. 3d 1321 (11th Cir. 2001) was a good example of how Florida's homestead law created opportunities for abuse. In response to a certified question from the Eleventh Circuit Court of Appeals, the Supreme Court of Florida held that a homestead acquired by a bankruptcy debtor with the specific intent to hinder, delay or defraud creditors is not excepted from the Florida constitutional exemption of homestead property from forced sales. On December 19, 1990, a Federal District Court entered a judgment against an individual for $15 million and the judgment became enforceable on January 2, 1991. Meanwhile on December 30, 1990 the individual, who lived in Tennessee, purchased a retirement home in Florida for $650,000. In 1992, the individual filed a petition under Chapter 7. The District Court determined that the debtor's using $650,000 of non-exempt funds to acquire an exempt Florida homestead was a fraudulent transfer and was made with the intent to hinder, delay or defraud his creditors. Notwithstanding the equities that were present, the Florida Supreme Court found that the Florida constitution superseded any fraudulent conveyance principles. Based on Havoco, a debtor who found himself in serious trouble with his creditors and was hemmed in by a fraudulent transfer or fraudulent conveyance act, could protect assets by acquiring a Florida homestead.

BAPA closes this loophole by imposing residence requirements and reducing the exemption from fraudulent or new additions to the homestead value made within a defined period prior to bankruptcy. Although the general effective date of the BAPA is October 17, 2005, the residency and homestead exemption amounts are effective in bankruptcy cases filed on or after April 20, 2005, the date of enactment. Not only must the debtor utilize the exemptions of his or her prior state until the debtor has resided in a new state for at least two years, but the debtor may not claim a homestead exemption of more than $125,000 unless the debtor has resided in the more generous state for at least 40 months prior to filing bankruptcy. §322.

Section 308 of the Act reduces the value of a debtor's homestead exemption to the extent any additions to the homestead's value were a result of a disposition of non-exempt property made by the debtor with the intent to hinder, delay or defraud creditors during the ten years prior to the bankruptcy filing. Thus, to the extent property is disposed of by a debtor and, in an attempt to defraud his creditors, uses the funds from the disposition to build an addition to his residence, the amount of the homestead exemption would be reduced by the value of the property disposed of. §308.

Another rule relating to additions provides that any new value in excess of $125,000 added to a homestead may not be included in a state homestead exemption regardless of intent if the transfer was made within the 1,250 days (about 40 months) preceding the bankruptcy filing, unless: (1) the added value was transferred from another homestead in the same state; or (2) the homestead is the primary residence of the family farmer. §322.

In addition, individuals who have engaged in criminal conduct cannot shield their homestead assets from those who they have defrauded or injured. The $125,000 cap is made permanent for filers convicted of specified felonies, including violations of federal or state securities laws, or who commit a criminal act, intentional toward or willful or reckless misconduct that causes serious physical injury or death within five years preceding the bankruptcy. §322.

In addition, under §330, discharges to Chapters 7, 11 and 13 debtors are delayed while a proceeding is pending which could result in the invocation of the $125,000 cap under §322.

VIII. FRAUDULENT CONVEYANCE CONSIDERATIONS.

A. Applicable Law.

Uniform Fraudulent Conveyance Act (MCLA 566.11-.23) was repealed effective December 30, 1998. Michigan adopted the Uniform Fraudulent Transfer Act effective December 30, 1998; MCLA §566.31-566.43.

B. Definitions.

1. "Creditors" include not only those who have liquidated claims or judgments but also those with contingent, unmatured, unliquidated, fixed, disputed, undisputed, legal, equitable, secured or unsecured claims. A bank holding a personal guarantee is a creditor for fraudulent conveyance purposes even though no default has occurred on the underlying obligation. This would fall under the category of a contingent claim.

2. A transfer by a debtor is "fraudulent" as to a creditor, whether the creditor's claim arose before or after the transfer was made if the debtor made the transfer (i) with actual intent to hinder, delay or defraud any creditor of the debtor or (ii) without receiving a reasonably equivalent value in exchange for the transfer and (a) the debtor was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction or (b) the debtor intended to incur, or believed or reasonably should have believed that he or she would incur debts beyond his or her ability to pay as they became due. MCLA §566.34(e).

In determining "actual intent", the statute lists a number of factors to be considered which include (i) whether the transferee was "an insider" as defined under the Act (a relative or an entity in which the debtor had an ownership interest or was a general partner, officer, director or is in control); (ii) retention of control of the transferred properties; (iii) whether the transaction was concealed; (iv) prior to the transfer a suit had been commenced or one threatened against a debtor; (v) the transfer was of substantially all of the debtor's assets; (vi) the debtor absconded; (vii) the debtor removed or concealed assets; (viii) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; (ix) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; (x) the transfer occurred shortly before or shortly after a substantial debt was incurred; (xi) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor. MCLA §566.34(4)(2).

C. **Remedies**.

MCLA §566.37 describes the remedies available to a creditor who is a victim of a fraudulent conveyance. Similar to the provisions of the now repealed Uniform Fraudulent Conveyance Act, the creditor can seek avoidance of the transfer to the extent necessary to satisfy the creditor's claim. MCLA §566.38 establishes the circumstances under which an innocent purchaser takes free of the creditor's claims.

D. **Statute of Limitations**.

MCLA §566.39 establishes the statute of limitations. The cause of action is extinguished unless the action is brought within one year after the transfer was made or the obligation was incurred if (i) the transfer was made to an insider for an antecedent debt, (ii) the debtor was insolvent at that time and (iii) the insider had reasonable cause to believe that the debtor was insolvent.

As to other fraudulent conveyance claims, the statute of limitations is the greater of (a) six years after the date the claim accrues or (b) in the case where a person who is liable for any claim and who fraudulently conceals the existence of the claim or the identity of any person who is liable for the claim from the knowledge of the person entitled to sue on the claim, the action may be commenced at any time within two years after the person who is entitled to bring the action discovers, or should have discovered, the existence of the claim or the identity of the person who is liable for the claim, although the action would otherwise be barred by the period of limitations.

E. **Concerns about future creditors**.

1. MCLA §566.34(4)(1) defines "creditors" to include creditors whose claims arise after the transfer (so-called "future creditors"). There is no further discussion in the statute on this issue. Current law suggests that future creditors, in order to obtain protection, must show that actual fraud with a specific intent to defraud the identified subsequent creditor, was present. See Hulbert v Shakelton, 560 So. 2d 1276 (Fla. Dist. Ct. App. 1990).

2. Asset protection plan which includes the transfer of assets but without invoking the badges of fraud such as transferring all of the assets of the transferor, rendering the transferor insolvent, etc., will generally not result in the unnamed, unidentified subsequent creditor being able to void the transfer as being fraudulent.

3. In Peter Spero's Treatise, Asset Protection - Legal Planning and Strategies, the author states that the term "future creditors" in both the Uniform Fraudulent

Conveyance Act and the Uniform Fraudulent Transfer Act is narrowly defined. In the context of defrauding future creditors, he states that "it generally means a creditor who presently holds contingent, unliquidated, or unmatured claims, all of which are included in the definition of the term "claim" under the various fraudulent transfer laws, or one who holds a claim that is reasonably foreseen by the transferor". See Stauffer v Stauffer, 351 A.2d 236, 245 (Pa. 1976) (a "future creditor" is "one with a legal claim against a person at the time that person makes a conveyance, even if the claim is not one that has been reduced to judgment or even filed, [e.g., contingent, unliquidated or unmatured claim] . . . who is entitled to set aside a conveyance if he can show it was made with actual intent to hinder, delay or defraud present or future creditors"). See also Leopold v Tuttle, 549 A.2d 151, 154 (Pa. Super. 1988), to the effect that the term "future creditor" also encompasses claims that are reasonably foreseen as arising in the immediate future. In short, a future creditor does not exist unless a conveying party can reasonably foresee incurring a claim or judgment at the time of conveyance."

Spero further states that "if the transfer is made with the requisite fraudulent intent directed toward a future creditor, then such intent must be contemporaneous with the transfer, or there must be some other connection between the two elements so that it can be said that the transfer is intended to injure the future creditor". There must be some identification of a particular creditor and not any possible future creditors. See Rolland v United States, 838 F.2d 1400 (1988).

4. Some planners, faced with a client having pending claims, will attempt to quantify the amount of such claims, leave sufficient assets to comfortably cover the claims and feel confident about transferring the balance to a spouse, partnership or foreign trust. The rationale is that the requisite intent to defraud is lacking since the debtor has essentially done just the opposite - he has attempted to determine his debts and ensure sufficient assets to pay them. Moreover, he is not left insolvent, he is able to pay his debts as they mature and he has an adequate reserve of funds.

The following cases bring this strategy into question. "It does not matter if the transferor retains property ample to pay his creditors." Heffernan v Bennett & Armour, et al., 239 P.2d 129 (1952). See also Severance v Knight-Counihan Company, 177 P.2d 4 (1947). The fact that creditors at the time of the transfer could have been satisfied is deemed irrelevant. This author believes that the strategy is sound provided the client's intent is not fraudulent as to his creditors – a question of fact. Heffernan and Severance appear to state the obvious - if there is a finding of fraudulent intent, other indicia, though favorable to the transferor, will not be controlling.

F. **Money Laundering Control Act**.

18 USC 1956 and 1957, originally enacted in connection with the control of drug related criminal activities also reaches fraudulent conveyances in contemplation of a bankruptcy proceeding.

IX. BANKRUPTCY CONSIDERATIONS.

A. **Creditors rights in bankruptcy**.

1. If the client is forced to declare bankruptcy or is involuntarily forced into bankruptcy, the creditor has numerous opportunities to reach transferred assets. The Bankruptcy Code has its own set of fraudulent conveyance rules and reaches transfers made within two years of the filing of the bankruptcy petition if fraud, either actual or constructive, is found. BAPA §1402(1) – (3).

2. Assuming that the assets are already in an offshore trust, it may be impossible for the Bankruptcy Court to obtain control over the transferred assets despite its entitlement to do so under the Bankruptcy Code. However, in such cases, it is unlikely that the debtor will obtain a discharge.

3. Not only may a discharge be denied because of a fraudulent transfer, creditors can continue to pursue claims against the debtor who may be subject to contempt and possibly incarceration if he is unable to retrieve assets from the foreign trust. See the Anderson and Lawrence cases discussed at IX K below. However, see In re: Jennings, 184 Cal. Rptr. 53, 58 (1982) where a California court refused to order involuntary servitude in contravention of Thirteenth Amendment to Constitution.

X. FOREIGN SITUS TRUST.

A. The structure.

The structure is exceedingly simple. Client transfers $1,000,000 in cash and securities to a domestic limited partnership. The partners of the limited partnership are client (or his 100% owned limited liability company), as a 1% general partner, and Client Offshore Family Trust, as the 99% limited partner. This structure meets the client's objectives since he will have complete control of the transferred assets in his capacity as general partner of the limited partnership. All investment decisions, the payment of management fees, distributions and other partnership decisions are under the sole control and dominion of the general partner. So long as client avoids a major malpractice or other catastrophic event, the structure will remain unchanged. However, if a significant judgment against client becomes imminent or some other event occurs suggesting a strong likelihood that client's assets may become exposed to creditors' claims, the partnership would be immediately liquidated. Client would then receive his 1% share and the limited partner its 99% share. To be prudent, Offshore Trust Company, the trustee of Client Offshore Family Trust, would proceed to remove the assets from the United States and place them offshore consistent with the objectives and directions set forth in the enabling trust instrument.

B. Estate planning.

The foreign situs trust will include all of the planning mechanisms normally found in a traditional estate plan. Since the client can die at any time the trust structure is in effect, all of the normal marital trust planning including the continuation of the trust for purposes of delayed distributions to children and grandchildren will be present. The contribution to the trust can be structured as an incomplete gift for federal gift tax purposes in which case the entire trust corpus will be includable in the estate of the decedent client and federal estate taxes as well as state death taxes will need to be dealt with. The trust can be structured so that the gift is treated as completed for gift tax purposes and thus be able to exclude the trust's asset from client's estate. In either case, since the client's assets which have not been fed into the offshore structure will be subject to a separate set of estate planning documents, it is critical that the two plans be carefully coordinated to ensure compliance with the client's overall objectives and minimization of federal and state taxes.

C. **Creditor issues**.

Considering the aforementioned structure, the judgment creditor has a formidable task ahead of him. Assuming that client has inadequate assets to satisfy the judgment, the judgment creditor must look to the assets of the foreign situs trust as the only source of recovery. Numerous obstacles stand in the way of the creditor accessing those assets.

The likely progression of events should include a creditors examination during which there would be a full disclosure of the date and circumstances surrounding the establishment of the partnership and trust, their purpose, and the dates and value of assets originally and subsequently transferred. If the arrangement is carefully explained and understood by the judgment creditor and his counsel (and possibly his counsel's "creditors' rights" counsel), it is likely that the judgment will be settled for pennies on the dollar at this stage. This probable result stems from the fact that no United States court will have the jurisdiction to compel the trustee of the foreign situs trust to disgorge assets in favor of client's creditors. If the creditor refuses to settle and insists on trying to reach the trust's assets, he will have to initiate litigation in the jurisdiction where the trust is established and seek to reach the assets on the basis of fraudulent conveyance concepts unless the foreign jurisdiction extends comity to U.S. judgments. See, for example, Sections 28 and 29, Nevis International Exempt Trust Ordinance of 1994.

The effectiveness of placing assets overseas will depend, to some extent, upon whether the foreign country selected as the trust situs will extend comity to U.S. judgments. Under Cayman Islands law, if a foreign country recognizes the judgments of the Cayman Islands, the Governor, pursuant to the Reciprocal Enforcement Act, may recognize a judgment of the foreign country. Thus, a foreign judgment (of a U.S. court) that is registered in the Cayman Islands may be enforced. But to what effect? The judgment is against the settlor - not the foreign trust. In contrast, by statute, U.S. bankruptcy proceedings do not affect the validity of a trust formed under the laws of the Cook Islands nor is comity extended.

The fraudulent conveyance laws in a number of these jurisdictions are relatively new and have clarified some of the historically fuzzy issues concerning future creditors and what constitutes a fraudulent conveyance. See Bahamas Fraudulent Dispositions Act, 1991, effective April 5, 1991; Cayman Islands: The Fraudulent Disposition Law 1989 (Law 15 of 1989), effective May 1, 1999; and Cook Islands International Trusts Act of 1984, as amended in 1985, 1989, 1991 and 1995-1996. Moreover, the statute of limitations periods in some of these jurisdictions have been legislatively fixed so as to preclude fraudulent conveyance claims if the requisite period has run prior to the commencement of the creditors' lawsuit in the foreign jurisdiction. The statute of limitations in the Cayman Islands is six years from the date of disposition (Section 4.(3)); statute of limitations in Bahamas is two years from the date of disposition (Section 4.(3)); and, the statute of limitations in the Cook Islands is two years from the date of the settlement or disposition to an international trust or in the case of a creditor claiming the property was disposed of to the international trust with the intent to defraud a creditor one year from the date the trust (as defined in the statute) is created. Since the efficacy of the asset protection trust structure is based in large part on the client's ability to transfer assets to the trust without the transaction constituting a fraudulent conveyance, strict attention must be paid to assuring that none of the badges of fraud are present.

The obstreperous creditor will find that the cost of litigating in a foreign jurisdiction is expensive and that contingency fee arrangements with local law firms are rarely available. Therefore, the personal injury lawyer and his client will be faced with a dilemma. Should they underwrite a substantial legal expense to chase the trust's assets when the outcome is so speculative, or should they make a less than favorable settlement and be done with it. A settlement seems to be the more likely choice. Consider the laws of Nevis. In Nevis, every creditor initiating proceedings against trust property is required to deposit $25,000 in cash with the Ministry of Finance. Nevis law also specifically prohibits contingency fee litigation. Thus, the creditor is burdened with paying significant upfront fees and costs to reach the assets of a debtor's Nevis trust.

In the course of explaining the structure to client, client makes an astute observation. Since he intends to continue working and generating substantial earnings, he questions whether his creditor will be able to garnish his earnings and ultimately obtain full payment in that manner. Indeed, if the structure did not contemplate the possibility of client's future earnings being available to the claims of his judgment creditor, it would be severely diminished as an asset protection planning approach. However, the structure recognizes the possibility of garnishment and suggests this solution. In negotiations with the creditor, the creditor must be advised that his pursuing a claim against the future earnings of client will force client to file for bankruptcy. If client actually files, and assuming that there has been no violation of §727 of the Bankruptcy Code, client's debt to the creditor will be discharged. 11 U.S.C. §727 (1979); see particularly §727(a)(2). Faced with this very real threat, it is likely that settlement with the creditor will quickly ensue.

D. **Special trust provisions**.

1. **Anti-duress clause**. It is essential that the trustees not be obligated to respond to instructions or directions which are contrary to the settlor's intent. Accordingly, very precise language is incorporated into the trust instrument making it clear that the trustees are prohibited from acting when the directions are the result of a court order, or other involuntary mandate imposed upon the settlor, a domestic trustee or the foreign trustee.

2. **Right to change trustee and "flight clause"**. For a number of reasons, the settlor will want to retain the right to change the trustee or the jurisdiction under which the trust is administered or both. This may be a result of the settlor's dissatisfaction with the trustee's services and/or its fees, concern about the trustee's stability, concern about the jurisdiction in which the trust was established (therefore desiring to change to a new jurisdiction where a new trustee will act), or perhaps the laws of the jurisdiction in which the trust was established have become unfavorable from a creditor protection standpoint, tax standpoint or otherwise and a new jurisdiction is necessitated. For these and other reasons, settlor retains the right to change the trustee to anyone other than himself and his spouse. While such a retained right would normally destroy the tax advantages sought through

irrevocable trust arrangements, this trust structure is intended to be tax neutral and this retained right is just another factor in finding the trust to be a grantor trust. But note that the existence of a so-called flight clause may result in the trust being characterized as a foreign trust for U.S. tax purposes. See the discussion below for further amplification of this subject.

3. **Trust protector**. A trust protector concept is common in jurisdictions outside the United States and involves the settlor having the right in the trust instrument to appoint a person to act as an advisor or ombudsman to the trustees. Some of the protector's powers are advisory - others may have substantial teeth including the right to remove the trustee, change the jurisdiction of the trust, change the beneficiaries, etc. The trust protector does not have the normal fiduciary duties of a trustee but acts in a quasi-fiduciary status… a liaison between the trustees and the beneficiaries.

E. **Relevant factors in selecting trust situs**:

1. Language.

2. Physical accessibility.

3. Stability of government.

4. History and sophistication of financial institutions.

5. Costs.

6. Applicable law including particularly fraudulent conveyance laws and statutes of limitation.

7. Favorable tax laws.

8. Comity.

9. Reputation.

F. **Grantor trust tax issues**.

An irrevocable trust established as a grantor trust creates a tax neutral structure.

1. When the grantor is regarded as the owner of a trust, the income attributable to the trust is taxable to him. The grantor is considered the owner if he or she can exercise dominion and control over the trust. A grantor will be treated as the owner of a trust if he or a non-adverse party or both has a power to dispose of the beneficial enjoyment of the corpus or interest income. Reg. 1.674(a)-1.

2. Since the objectives of establishing the trust include the retention of as much control as possible over the trust assets while, at the same time, seeking tax neutrality, the grantor retains for himself a wide variety of powers which specifically affect the beneficiaries' beneficial enjoyment of the corpus or income. For example, it is not unusual for the trust to reserve to the grantor the right to veto any proposed distributions to beneficiaries, to add or delete beneficiaries, and the power to remove the trustee. These powers, among

others, will undoubtedly render the trust a grantor trust under IRC §§671-677 of the Code. See also Reg. 1.674-(d)(2)(a) and (b). The grantor may also be deemed to have a greater than 5% retained interest as a result of the trustee's right to terminate the trust and distribute trust corpus to the grantor. This will also render the trust a grantor trust. IRC §673.

G. **Other tax aspects**.

1. The Taxpayer Relief Act of 1997 repealed IRC §1491 which had provided that a transfer of appreciated assets to a foreign trust triggers a 35% excise tax in the amount of the appreciation under IRC §1491. This excise tax was probably not applicable to the typical asset protection trust because the trust was a grantor trust (Rev. Rul. 87-61, 1987-2 C.B. 219). However, see below the discussion of IRC §684 which replaced IRC §1491.

2. Reporting Requirements. The trust will be required to file Treasury Form 90.22-1 to report the existence of any foreign accounts if the amount held in such foreign accounts had a combined value of more than $10,000 at any time during the year. Other forms that may have to be filed in connection with an offshore structure include the following:

a. Form 56 - Notice Concerning Fiduciary Relationship;

b. Form 926- Return by a Transferor of Property to a Foreign Corporation, Foreign Estate or Trust, or Foreign Partnership;

c. Form 3520 - Creation of or Transfers to Certain Foreign Trusts;

d. Form 3520-A - Annual Return of Foreign Trust with U.S. Beneficiaries;

e. Customs Form 4790 - Report of International Transportation of Currency or Monetary Instrument;

f. Form 1041 - U.S. Fiduciary Income Tax Return;

g. Schedule B, Part III, Individual Federal Income Tax Form 1040. The grantor of, or transferor to, a foreign trust must report this fact. The question is whether the trust is a foreign trust.

h. Reporting requirements and penalties for failure to report transactions involving foreign trusts have been dramatically changed. Code Section 6048 requires that a U.S. person who transfers property directly or indirectly to a foreign trust report such transfer to the Treasury Department within 90 days. The expatriation of a domestic trust caused by the new definition of foreign trust status may be a reportable event. If so, failure to comply with the reporting requirement will result in a penalty under Code Section 6077 equal to 35% of the total trust property.

3. No gift will occur upon the transfer of property to a trust qualifying as a grantor trust because the gift is considered an incomplete gift.

a. Reg. §25.2511-2(b) provides that if a donor reserves any power over the transferred property's disposition, the gift may be complete, or may be partially complete and partially incomplete, depending upon all the facts of the particular case. Under Reg. §25.2511-2(c), a gift is incomplete if the donor reserves the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves (unless the power is limited by an ascertainable standard).

b. The settlor must file a gift tax return in the year of the trust's creation, disclosing all relevant facts (including a copy of the trust) in order to advise the Service of the incomplete gift. Regs. 25.2511-2(j) and 25.6019-3(a). This is also necessary to cause the statute of limitations to commence to run.

4. Structure is tax neutral because the limited partnership and trust are both flow-through entities. The client is in the identical position he would have been, taxwise, in the absence of this structure.

H. **Foreign or domestic trust status**.

The characterization of a trust as foreign or domestic was clarified by provisions of the Small Business Job Protection Act of 1996, related proposed Regulations issued in June of 1997 and the Taxpayer Relief Act of 1997. Prior to enactment of the 1996 Act, various criteria were analyzed to determine trust status. Factors such as the residence of the trustees, residence of the beneficiaries, where the trust was administered, where the records were maintained, the location of trust assets and the law under which it was established were all weighed in determining whether a trust would be treated as a foreign or domestic trust. The rules are now much clearer.

1. Under new Code Section 7701(a)(30) and Code Section 7701(a)(31), a trust is a U.S. person for purposes of the U.S. income tax only if both of the following conditions are satisfied:

a. A court within the U.S. is able to exercise primary supervision over administration of the trust, and

b. One or more U.S. fiduciaries have the authority to control all substantial decisions of the trust.

2. Trusts that had been previously thought to be domestic trusts because of the great weighing of factors in favor of domesticity, will now fail to meet the statutory rules if no court within the U.S. can exercise supervision over administration of the trust. Thus, foreign status would be applied irrespective of the fact that all of the trustees, beneficiaries, assets, records and decision making occurs within the United States.

3. A trust formerly thought to be a domestic trust will automatically become a foreign trust on January 1, 1997 unless prior to such date it was amended to comply with the new definitional sections under 7701.

4. As with any new legislation, numerous questions regarding the definitions arise. The factual question of whether a court within the U.S. is able to exercise

primary supervision over administration of the trust may not be clear cut when the trust is created under the laws of a foreign jurisdiction but all of its beneficiaries and trustees are U.S. persons residing in the U.S. What if there are multiple trustees, at least one of whom is foreign and one of whom is a U.S. person. Does the U.S. fiduciary have the authority to control all substantial decisions of the trust. What if the trust instrument is vague on this point?

a. Prop. Reg. §301.7701-7 sets forth examples of how a trust can comply with the "court supervision" test:

i. A trust will meet this requirement if it is registered by an authorized fiduciary in a court within the United States under a state statute that has provisions substantially similar to Article VII of the Uniform Probate Court.

ii. A testamentary trust can meet this requirement if it is created pursuant to terms of a Will probated within the United States (other than an ancillary probate), if all fiduciaries of the trust have been qualified as trustees of the trust by a court within the United States.

iii. An inter vivos trust can meet this requirement if the fiduciaries and/or beneficiaries take steps with a court within the United States that causes the administration of the trust to be subject to the primary supervision of the court.

b. The regulations also offer examples of what the IRS would consider substantial decisions that must be subject to the supervision of the court. These decisions include, among other things, the amount of distributions, the selection of a beneficiary, investment decisions, whether the trust should be terminated, and whether to remove, add or replace a trustee.

5. **Issues affecting foreign trusts with a U.S. Grantor**.

a. To the extent a U.S. person makes a transfer to a foreign trust, during the period the U.S. transferor is alive and so long as the trust has at least one U.S. beneficiary, the trust will be treated as a grantor trust (to the extent of such U.S. person's transfers). This will have the effect of taxing a proportionate share of trust income to the transferor who may not be a beneficiary of the trust and will receive no distributions from which to pay the tax.

b. Any non-resident alien who becomes a U.S. citizen or resident will be treated for U.S. tax purposes as the grantor of any property including undistributed income, appreciation and gains transferred by such person to a foreign trust within a five year period preceding the date the transferor becomes a U.S. citizen or resident. This provision creates consistency between longstanding U.S. persons and those who have recently become U.S. persons regarding the tax effects of their being grantors of a foreign trust.

c. The 1996 Act imposed an excise tax on the migration of a U.S. trust to a foreign trust. The U.S. citizen or resident is considered to have made a distribution to a foreign trust on the day of migration and the property is subject to a 35% excise tax on the difference between the fair market value and the adjusted basis of the property. An election is available to treat the transfer as a sale at fair market value.

d. IRC §684 provides that any transfer of property by a U.S. person to a foreign trust will be treated as a sale or exchange for an amount equal to the fair market value of the property transferred and gain will be recognized on the excess of fair market value over the property's adjusted basis. However, §684(b) provides an exception to the general gain recognition provision when and to the extent any person is treated as the owner of the trust under §671 (the grantor trust rules). Rev. Rul. 87-61 established the same exception with respect to now repealed §1491.

e. What happens when the grantor dies resulting in there no longer being any person who is a U.S. grantor. Will this trigger the tax under IRC §684? Neither the statute nor its legislative history answers this question. However, even if IRC §684 were to apply, since the trust assets are included in the grantor's taxable estate, they will receive a step up in basis to their date of death fair market value which would have the effect of eliminating any unrealized appreciation that would be subject to IRC §684. Also, IRS officials have informally indicated that they have no intention of imposing the §684 tax in this situation on top of the estate tax.

f. Grantor trusts are usually eligible to hold stock in an S corporation however foreign trusts treated as grantor trusts are not eligible as stockholders.

g. If a trust formerly characterized as a domestic trust becomes a foreign trust under the new rules, payors of income such as interest, dividends, annuities or other fixed or determinable annual or periodic gains, profits, and income may be required to withhold from the payment of such items a tax equal to 30% or lower treaty rates as applicable.

6. **Notice 96-65**. Some remedial announcements were made to lessen the impact of the 1996 Act and provide additional time for taxpayers to assimilate the new rules. Under Notice 96-65, 1996-52 IRB, certain existing trusts that desire to remain domestic trusts and which would have difficulty meeting the new domestic criteria before the first tax year beginning after 1996 may continue to file tax returns as a domestic trust for tax years of the trust beginning after 1996 if the trust satisfies the conditions of the Notice. These conditions include (1) the trustee requiring to initiate modification of the trust and conform with the domestic trust criteria by the due date (including extensions) for filing the trust's income tax return for its first tax year beginning after 1996, (ii) the trustee must complete the modification within two years of that date; and the (iii) trustee must attach a statement to the trust's income tax return titled "Election to Rely on Notice 96-65 to File as a Domestic Trust".

7. **Planning Thoughts**. Where tax motivations are lacking, such as in the typical asset protection trust, it would appear at first blush that it is advantageous to retain domestic trust status as opposed to foreign trust status. The question then arises regarding the creditor protection afforded the grantor if a U.S. court is able to exercise primary supervision over the administration of the trust and there is at least one U.S. fiduciary who has control over substantial decisions of the trust (and who will undoubtedly then be subject to jurisdiction in the United States). It is this author's opinion that since these trusts are

established with the primary goal of protecting assets these should be established outside the reach of U.S. courts irrespective of the somewhat greater administrative burden that may ensue.

I. **The trustee**.

1. Choice of a trustee is critical to the overall effectiveness of an asset protection plan. It is important that you select a trustee that has experience with these types of trust structures. They will be in a position to promptly review the draft trust submitted to it and be responsive to the need to consummate the required transactions within a reasonable time period. Costs should be carefully reviewed including the initiation and review fees, charges for the bank's counsel, and yearly fees. Additionally, make sure to inquire about the fees that the trustee will charge if and when the assets of the limited partnership are transferred to the trustee.

2. The trustee and client should meet in person and the client should discuss his thoughts, objectives and concerns regarding the trust structure. If a rapport and understanding cannot be achieved, another trustee should be interviewed.

3. The trustee should not have a nexus to the United States inasmuch as a domestic court may be able to impose controls over the trustee through its U.S. relationship.

4. The trustee will have a high degree of concern with the "legitimacy" of the transaction. Not only will it undertake its own due diligence to ascertain that the client is not involved in some criminal operation but will also be inquiring into fraudulent conveyance issues. Many trustees have established their own criteria for how much the settlor can contribute to the trust structure based upon the settlor's total net worth. Their purpose is to avoid litigation and to ensure a totally clean transaction. They are not looking to win the lawsuit but to avoid one in the first place.

J. **Other considerations**.

The stacking of the limited partnership with the foreign situs trust provides effective asset protection while, at the same time, allowing the client to retain the greatest possible control over his assets. Commentators have disparaged this program because the more control that the client maintains over the assets, the more likely it is that in a contested proceeding the client's creditor will be able to access the assets - even if by such time the assets have been removed to a foreign jurisdiction. The thrust of the anti-stacking group is that if the client is seeking true asset protection, he should be willing to give up all control opportunities in favor of a stronger, more defensible asset protection plan. It is argued that the assets should be contributed directly to the offshore trust with the foreign trustee being the sole trustee of the trust. So long as there is no fraudulent conveyance to the trust, the assets should be free from the reach of creditors.

K. **Attacks on asset protection trusts**.

1. <u>Federal Trade Commission</u> v <u>Affordable Media, LLC, et al.</u> (also known as the "<u>Anderson</u>" case. No case has created greater consternation among both asset protection planning advisers and asset protection planning clients than the <u>Anderson</u> case.

The Andersons, Denyse and Michael, owned Affordable Media, LLC. Their telemarketing scheme turned out to be a Ponzi scheme as their promised 50% return in 60 to 90 days faltered and the company was only able to pay its initial investors by using the monies of later investors. The Federal Trade Commission then sued on behalf of thousands of investors to recover their investment dollars. In the meantime, the monies had been transferred to what one might fairly describe as a typical offshore asset protection trust in the Cook Islands.

The U.S. District Court in Nevada ordered the Andersons to retrieve the funds from the offshore trust. As trustees, the Andersons should have been able to do so except for the "anti-duress" clause in the trust agreement which automatically terminated the trustees' position and defeated the request since the genesis of the Andersons' request was a U.S. court order to retrieve the assets of the trust. Since the Court had no jurisdiction over the trust or its assets, it held the Andersons in contempt for failing to effectuate the repatriation of the trust assets. The Andersons claimed impossibility, which is a defense to a contempt charge, but the Court rejected this defense. The Andersons went to jail. See "Asset Protection after Anderson: Much Adieu About Nothing?", Journal of Asset Protection Planning, December 1999, Vol. 26/No. 10 for an excellent discussion on the constitutional issues regarding the doctrine of impossibility in connection with a civil contempt charge.

Several things about the Anderson case are noteworthy to the asset protection planning bar and those who might consider settling an offshore trust. The Andersons should not have been the trustees of their trust. By having such control and then having it automatically relinquished because of the anti-duress clause language, the Court was outraged at their claimed inability to exercise their rights as trustees. The Andersons were also named protectors of the trust – a position that is common in jurisdictions outside the United States and places persons in the position to act in an informal capacity as an ombudsman or as a liaison between the trustees and the beneficiaries. Other factors undoubtedly led to the wrath of the District Court namely, the illegal scheme that gave rise to the unrepatriated funds, the fact that it was curious that the trust was established shortly before the commencement of the illegal venture and the Court's unwillingness to believe that the Andersons could not, under any circumstances, cause the foreign trustee to respond to their wishes. Also, fraudulent conveyance and fraudulent transfer laws would have rendered the transferred funds subject to disgorgement in favor of the defrauded creditors, i.e. those future creditors of the Andersons who were induced to invest in the Ponzi scheme.

So what became of the Andersons? The author of this manuscript has been told but has not verified that the Andersons spent six months in jail for contempt. According to an FTC release, in January of 2003 the Andersons settled with the FTC for $1.2 Million after the FTC commenced a separate lawsuit in the Cook Islands against the trustee, AsiaTrust Limited. The FTC dismissed all its claims including the $20 Million judgment. So the Andersons ended up paying about six cents on the dollar and they kept about $5 Million of their illegally amassed trust fund. The message is that even the most egregious abuses of asset protection planning can be effective.

If this was the result in the Anderson case, imagine how effective asset protection planning can be for a legitimate program in full compliance with the fraudulent conveyance and fraudulent transfer laws.

2. In Re: Stephan Jay Lawrence, Debtor v Allan L. Goldberg, Trustee, 279 F. 3d 1294 (2002).

In 1991 Lawrence created an offshore trust and funded it with approximately $7 million. Two months later an arbitration judgment was issued against him in the amount of $20.4 million. Numerous subsequent amendments to the trust occurred over time in each case attempting to further protect the assets of the trust from Lawrence's creditors.

In June 1997, Lawrence filed a voluntary petition in bankruptcy. The bankruptcy trustee objected to the debtor's discharge. After a hearing, the court found that the rights and obligations of the trust were governed by Florida law, not the law of Mauritius, which is the applicable law established by the trust documents and further found that the trust was the property of the estate. Approximately two years later the bankruptcy trustee sought an order directing Lawrence to turn over the assets of the trust. At a status conference to determine Lawrence's compliance with the order, the court found Lawrence had control over the trust, through his retained powers to remove and appoint trustees and to add and exclude beneficiaries, and rejected Lawrence's impossibility defense. It then held Lawrence in contempt for failing to turn over the trust assets. The Bankruptcy Court then issued its contempt order, Lawrence failed to comply, and on appeal to the District Court the District Court affirmed both the turn-over order and the contempt orders. Lawrence appealed to the Fifth Circuit Court of Appeals. At the time the opinion was rendered by the Fifth Circuit Lawrence was incarcerated. He was being fined $10,000 per day until he purged his contempt. Like in Anderson, the issue of whether Lawrence was in contempt of a court order hinged on whether he was able to comply…the impossibility defense. "In order to succeed on the inability defense, the alleged contemnor must go beyond the mere assertion of inability and establish that he has made in good faith all reasonable efforts to meet the terms of the court order he is seeking to avoid". The appellate court reviewed the language of the trust as amended after the arbitration judgment and was unpersuaded that when Lawrence was made an excluded person (one that would not participate as a beneficiary of the trust) that this change was irrevocable and therefore he could not have been reinstated as a beneficiary at a later date. The court concluded "the import of these clauses and provisions, when read together, is that the appellant, as settlor and prospective beneficiary, retained *de facto* control over the trust through his ability to appoint trustees who could in their absolute discretion reinstate the appellant as a beneficiary and assign the entire proceeds to him."

Interestingly, the court also affirmed the District Court's finding that the 1993 amendment of the trust to add an anti-duress clause was void as to current and future creditors under Florida law where the settlor created a trust for his own benefit and relied on a spendthrift clause in the document. The clause was of a nature where it left to the settlor and the trustees the discretion to determine when an event of duress had occurred. The sole purpose of the provision appeared to the court to be an aid to the settlor to evade contempt while merely feigning compliance with the court's order. This provision would contravene public policy proscribing a debtor from shielding money placed in a trust for his or her own benefit and to the prejudice of legitimate creditors.

Lawrence played cute. When the District Court demanded that he turn over the trust assets to the bankruptcy trustee, he appointed the bankruptcy trustee a trustee of the trust. However, the bankruptcy trustee could not obtain control over the assets due to the anti-duress provision and the foreign trustee's compliance with it. As to the impossibility defense the court stated that Lawrence must demonstrate that he has made "in good faith all reasonable efforts" to meet the terms of the court order he is attempting to avoid. "We agree with the District Court that Lawrence's last-minute appointment of Goldberg as trustee does not meet the requirement of 'all reasonable efforts' nor do any of Lawrence's actions appear to have been made in 'good faith'." The court then addressed another nuance of the impossibility defense, namely that the claimed defense is invalid because the asserted impossibility was self-created. The court stated "where the person charged with contempt is responsible for the inability to comply, impossibility is not a defense to contempt proceedings." As to Lawrence's incarceration, the court felt "constrained" to remind the lower courts that, generally, civil contempt sanctions are intended to coerce compliance and that, at some point in time the incarceration would lose its coercive effect and violate contemnor's due process rights. The court then instructed the bankruptcy court to reconsider Lawrence's incarceration at reasonable intervals in order to assure that the contempt sanction continues to serve, and is limited to, its stated purpose of coercion.

XI. ATTORNEYS' ETHICS.

A. Counseling with Respect to Criminal or Fraudulent Conduct.

1. A lawyer shall not counsel a client to engage, or assist the client, in conduct that the lawyer knows is criminal or fraudulent. Michigan Rules of Professional Conduct 1.2(d). Thus, an attorney has a professional responsibility not to counsel a client or to assist a client in undertaking a transfer where such transfer is illegal or fraudulent. For liability of the attorney for civil damages as a co-conspirator see McElhanon v Hing, 151 Arizona 386, 728 P. 2d 256 (Ct. App. 1985); Pearce v Stone, 149 Arizona 567, 720 P. 2d 542 (Ct. App. 1986).

2. Attorneys who advise or assist their clients to engage in conduct that is violative of the Uniform Fraudulent Conveyance Act are subject to disciplinary proceedings. This type of activity may be manifested in several ways. Advising a client to make a transfer that the attorney believes would constitute a fraudulent conveyance is actionable. Advising a client to pay money into the attorney's trust account in order to "shield assets" from the client's creditors is likewise actionable. Whether the deposit made to the attorney constitutes a reasonable retainer versus a transparent plan to simply hide assets is a matter for the fact finder to determine. Not only is the attorney subject to disciplinary proceedings, his actions may constitute criminal activity under state law.

3. Various statutes give rise to potential criminal liability in connection with the hiding of assets. See 18 U.S.C. Sec. 1032 of the Crime Control Act of 1990 making it a federal crime to conceal assets from the FDIC or RTC. Also, 18 U.S.C. 1014 makes it a felony to submit a knowingly false statement in connection with a loan application. This is of great concern to the asset protection planner since he must clearly disclose to the client that once the plan is embarked upon and the assets irrevocably transferred, the client may no longer show the transferred assets on his balance sheet for either loan application purposes or other purposes.

4. The attorney should establish extensive due diligence procedures in connection with the screening of clients for asset protection planning. Financial statements, current business matters, pending or threatened lawsuits, marital status, anticipated changes in client's activities, etc. must all be studied.

B. **Additional Sources**.

Anyone interested in obtaining a greater depth of analysis regarding attorney liability and ethics considerations relating to asset protection should read the four part series written by William Siegel in the September/October 1997, January/February 1998, March/April 1998 and May/June 1998 issues of the Journal of Asset Protection.

XII. OTHER RECENT TRENDS.

A. **Montana Foreign Capital Depository Act**.

Asset protection planners advising U.S. based clients will almost universally look to offshore jurisdictions when contemplating the establishment of asset protection trusts. However, what about the non-U.S. based client who is interested in asset protection for the same reasons as his U.S. counterpart; the proliferation of litigation, excessive awards, lack of insurance availability, etc. The foreigner may also be concerned about political instability and economic upheaval. In most cases, the same foreign jurisdictions that are attractive to U.S. persons are equally attractive to non-U.S. persons. However, given the right circumstances, foreign persons would undoubtedly be more inclined to establish asset protection trusts in the United States where political and economic stability are arguably the strongest in the world. Alas, in 1997, the State of Montana moved to fill this need by enacting legislation to offer depository services to foreign persons and maintain the secrecy sought by such persons. Indeed, this law was praised by its backers as being wholly consistent with Montana's Constitution which is said to have the strongest statement regarding the recognition of the rights of individual privacy.

The legislation seeks to balance customer privacy and non-recognition of foreign judgments against legitimate U.S. government interests which include avoidance of money laundering and not aiding or abetting criminal activity or otherwise acting in a way contrary to the federal criminal statutory scheme. Such balance was achieved through rigorous "know your client" rules and restricting a client's access to funds on an immediate basis. In fact, the purchasing of precious metals as an investment together with a minimum holding period of 36 months is one specific provision of the Act.

B. **Prime Bank instrument fraud.**

A number of recent cases illustrate fraudulent schemes invested in by naive and greedy investors. Lawyers need to be vigilant in identifying such schemes and advising the client on minimal due diligence requirements. The recognition that an investment opportunity is "too good to be true" is a telltale sign for immediate rejection. Whether your client is accessed over the Internet or by direct mail, these programs all have similar enticements. Claims are made that the financial instruments which your client is acquiring are issued by well known international financial institutions such as the World Bank or the International Monetary Fund.

Often, these "opportunities" emanate out of either recognized financial centers or second tier developed countries such as Turkey, Portugal or Czechoslovakia. The selling materials refer to "prime" banks though there is no such designation recognized in the international financial arena. The instruments are often promoted as being "guaranteed" by a prime bank or secured by letters of credit issued by a prime bank. Often, statements are made that this opportunity is not available through major brokerage houses or financial institutions. The simple question should be asked: "Why am I being permitted to invest in this extraordinary opportunity when financially strong and sophisticated investment companies are either not aware of them or otherwise denied access?"

APPENDIX

TOOLS TO DEVELOP AN ASSET PROTECTION PRACTICE

A. **Promo Piece for Asset Protection Planning and Worksheet to Analyze a Client's Asset Protection Needs**.

B. **Assessing Vulnerability to Creditor Claims**.

FOR ASSET PROTECTION PLANNERS PROMO PIECE TO USE WITH OTHER PROFESSIONALS (CONTAINING A WORKSHEET TO ANALYZE A CLIENT'S) ASSET PROTECTION NEEDS

ALERT

ASSET PROTECTION PLANNING©

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<u>ALERT</u>

TO:	Business and Real Estate Attorneys, Bankruptcy Lawyers and Estate Planners
FROM:	Howard B. Young, Esq. 248.258.2700
ISSUE:	Have you adequately and effectively advised your clients about the need for asset protection? Are you and your firm at risk for not protecting your clients' assets?
DISCUSSION:	In today's world, **Asset Protection Planning** is no longer a fringe area of the law. As a result, in the course of representing your clients, it is not unreasonable for your clients to expect you to know whether they have a need for **Asset Protection Planning** and, if so, to provide such advice or bring in an expert to assist you in this area of the law.

I developed a worksheet which will assist you in analyzing a client's asset protection needs.

Not only will you be performing a value added service for your clients, which can lead to additional revenue generation for your firm, but you are avoiding a possible malpractice claim.

I am a recognized leader in this field with over 20 years of experience in helping clients structure their holdings to minimize exposure to creditors. I have authored an article on offshore trusts and have been a frequent lecturer at ICLE and other seminars speaking about various asset protection topics. I would be pleased to work with you and your clients in this complex and evolving area of the law.

DETERMINING THE NEED FOR ASSET PROTECTION PLANNING

Ask Your Clients These Questions

1. Have you accumulated wealth (portfolio assets, real estate, business interests, etc.)?

2. Are you really adequately insured against potential claims or do you just think you are?

3. Are you concerned that someone may sue you and get a judgment against you for which there is inadequate or no insurance?

4. Have you structured your holdings in a manner that makes it more difficult for a creditor to access your wealth in the event a significant judgment is obtained against you?

5. Do you want to be proactive in protecting your assets?

6. Do you realize that once there is a claim against your assets, it may be too late and it becomes much more difficult to protect your assets?

Have You Considered That
All of the Following Can Lead to Tort Liability
<u>and an Overwhelming Judgment</u>?

Operation of Automobiles and Watercraft.

Professional Malpractice.

Officers and Directors Liability.

Home Ownership.

Federal and State Tax Claims.

Personal Guaranties.

Divorce.

Withdrawal Liability in the Case of Multi-Employer Plans.

Environmental Issues.

Piercing of the Corporate Veil.

Sole Proprietorships and Partnerships.

Description of Program

You may have a need for **Asset Protection Planning**. I would like to set up a meeting and introduce you to our **Asset Protection Expert** to accomplish the following:

- Assess your risk profile
- Analyze your assets and determine which assets are subject to creditor claims and which assets are protected by law
- Explain the different options and strategies that can be initiated to better position your assets against attack by creditors

ASSESSING HOW VULNERABLE YOU ARE TO CREDITOR CLAIMS

Assets with Protection Features		*Assets with NO Protection*	
Assets you have given away (but not fraudulently transferred)	$	Assets you own in your own name	$
Assets held by the entireties (typically real estate but can also be used for certain intangible personal property)		Jointly held assets	
Interests in limited liability companies and partnerships		Stock in corporations, sole proprietorships	
Proceeds of life insurance payable on death; life insurance owned by an irrevocable life insurance trust		Cash value life insurance	
IRA's, 401(k)'s, profit sharing and pension plans		Checking and savings accounts, bonds, stocks, brokerage accounts, CD's, and money market accounts, vehicles, boats, airplanes	
Offshore Asset Protection Trust		Standard revocable living trust; offshore bank accounts	
Domestic Asset Protection Trust		Rights to income and principal held by beneficiary	
Homesteads		People who have recently moved; low homestead exemption states	
Special Needs Trusts		Support trusts	
Trusts for Minors		Custodial accounts (after age of majority)	

ASK YOURSELF: Have I protected enough of my assets by using the left hand column strategies so that if I lose all of my right hand column assets, I still have a comfortable nest egg?